

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2007 through the Fourth Quarter of 2010

Like the fall weather, the national economic outlook has cooled since the last *Forecast* was published in July 2007. This change can be seen in several economic measures. In July 2007, real GDP was expected to advance an average of 2.7% per year over the forecast period. In the current *Forecast* real GDP rises 2.4% annually. This difference may appear negligible, but as a result of the slower growth, real output is a quarter trillion dollars lower (2.0%) in 2010 compared to the previous forecast. The national employment forecast has also been scaled back. In fact, by 2010, there are nearly 1.1 million fewer jobs than in the July 2007 *Forecast*. Given the weaker employment forecast, it comes as no surprise real personal income loses ground over the next few years, coming in at \$10.9 trillion versus the previously anticipated \$11.0 trillion.

These comparisons of annual projections provide an overview of how the national economic climate has changed recently. However useful, focusing on the annual numbers mask other important changes. In order to get a better grasp on the depth and duration of the slowdown, we turn to quarterly data. In July 2007 it was reported the economy would cool during the second half of this year and the first half of next year. Specifically, after spiking at a 3.8% annual rate in the second quarter of 2007, real output growth would downshift to under 3.0%, where it would remain until the third quarter of 2008.

In terms of depth and duration, the slowdown in the October 2007 forecast is more severe than in the July 2007 forecast. Like in the previous forecast, real GDP growth drops below 3.0% beginning in the third quarter of this year. However, the current forecast's slowdown ends in the fourth quarter of next year. Thus, it is one quarter longer than its July 2007 counterpart. Because the recovery is delayed for one quarter, real GDP growth is weaker over this period. Specifically, real GDP expands 2.5% from the third quarter of 2007 to the third quarter of 2008. In comparison, real GDP increases 3.5% over this same period in the previous forecast.

While the details differ, both forecasts agree the economy will be fragile over the next few months. The most likely path for the current forecast is for the economy to avoid a recession and begin picking up steam again in the second half of next year and continue expanding through 2010. However, the possibility of a negative detour has increased since this summer.

According to Global Insight, Inc., there was a 20% chance in July 2007 the economy would turn in a subpar performance. In October 2007, the company raised the probability of a weaker-than-expected outcome to 30%. Unfortunately, not only has the likelihood of a slowdown increased since the summer, but also its severity. In the July 2007 pessimistic alternative, growth slows, but manages to just skirt a recession. The economy is not so fortunate in the October 2007 alternative forecast. In this scenario, the economy slips into a two-quarter recession beginning with the last quarter of 2007. Specifically, real GDP shrinks at a 0.4% annualized pace in the fourth quarter of 2007 and at a 0.8% clip in the first quarter of 2008. Hampered by the recession, real GDP averages just 1.6% annual growth over the forecast period, versus the 1.8% pace predicted in July 2007.

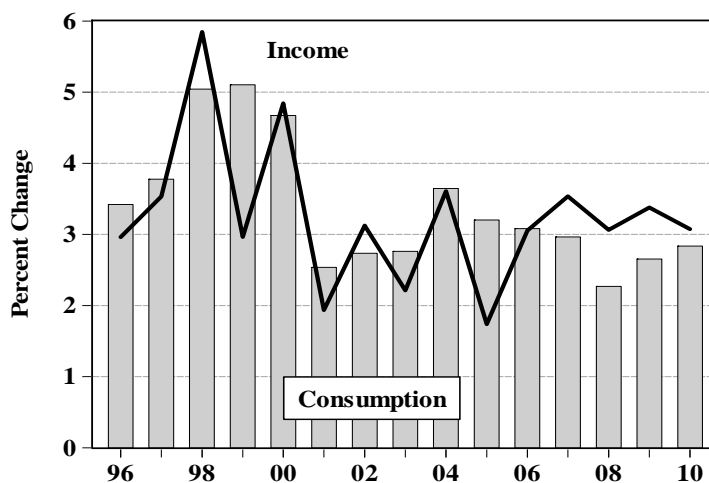
SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: American consumers are expected to spend within their means over the forecast period, which will be a change from their recent spendthrift ways. Real spending grew by at least 3.0% annually from 2003 through 2006, thanks in large part to the booming housing sector. The housing sector had a two-pronged impact on spending. First, consumers splurged on durable goods to fill their new abodes. Second, rising home values allowed giddy consumers to tap into their rising equity. In addition, a healthy job market gave consumers the confidence they needed to increase their debt burdens. But this confidence has been shaken recently by the interplay of tightening credit conditions and eroding home values. And rising energy prices have acted like a tax on consumers,

reducing disposable income. Spending rose a meager 1.4% during the second quarter of 2007. It is expected to bounce back to a 3.4% annual pace in the third quarter. However, this respite should be short lived, as the recent oil price climb above \$90 per barrel slows spending to a 2.1% annual pace in the third quarter of 2007. This slowing persists through the first half of next year, as home prices decline further. Tightening credit conditions and resets on variable-rate loans will cause more financial stress for highly leveraged homeowners. Sales of appliances, home furnishings, and decorations will be particularly hard hit. Specifically, after advancing nearly 12.0% in 2006, real spending on this category is forecast to expand by just 3.0% in 2008. Meanwhile, stubbornly high energy prices will impede the recovery in auto sales. Light vehicle sales are projected to average about 16 million units in both 2007 and 2008, which is well below their peak of 17.3 million units in 2000. As consumers watch alternative financing sources dwindle, real spending growth will fall in line with real disposable income growth. Real spending has expanded faster than disposable income growth since 2003. This gap was the widest in 2005 when spending increased 3.2% and income advanced 1.7%. Over the forecast period the roles for income and spending reverse, with the former growing faster than the latter in every year. Specifically, U.S. real disposable income is projected to rise 3.5% this year, 3.1% next year, 3.4% in 2009, and 3.1% in 2010. Real spending is predicted to increase 3.0% in 2007, 2.3% in 2008, and 2.7% in 2009, and 2.8% in 2010. One positive aspect of slower consumer spending is the U.S. personal savings rate is expected to rise from its 73-year low of 0.4% in 2006 to 2.4% in 2010.

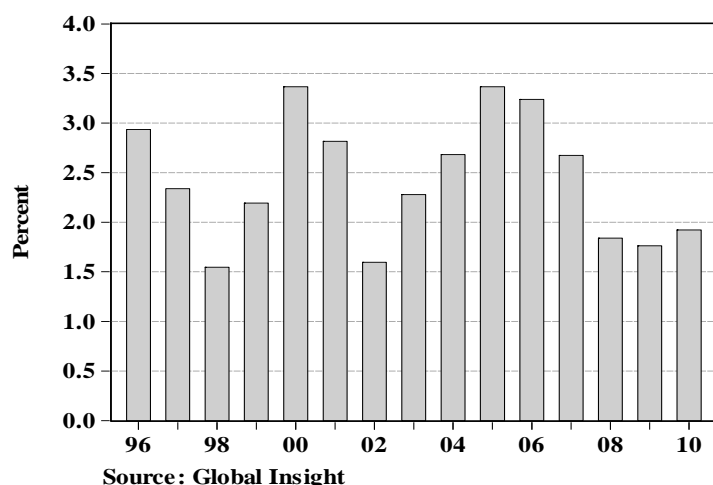
Inflation: Consumer inflation peaked in 2006 at 3.2% and should moderate over the forecast period. It will improve marginally at first, thanks to soaring energy prices earlier this year. The energy component portion of consumer inflation jumped at an annual 17.7% pace in 2007's first quarter followed by a 96.7% annual pace in the second quarter. Energy prices should ease in the second half of this year, but not nearly enough to offset the earlier run up. For example, the retail price of gasoline rose from \$2.33 per gallon to \$3.06 per gallon from the end of last year to the second quarter of 2007, a 31.3% jump. But it is projected to drop just 9.5% to \$2.77 per gallon by the end of this year. It should remain above \$2.70 per gallon for the duration of the forecast. Given the relative stability of energy prices, more attention will turn to employment costs. These costs are expected to advance steadily at about a 3.0% pace over the next few years. Wages should be the slowest growing component of these costs, rising about 3.0%

U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

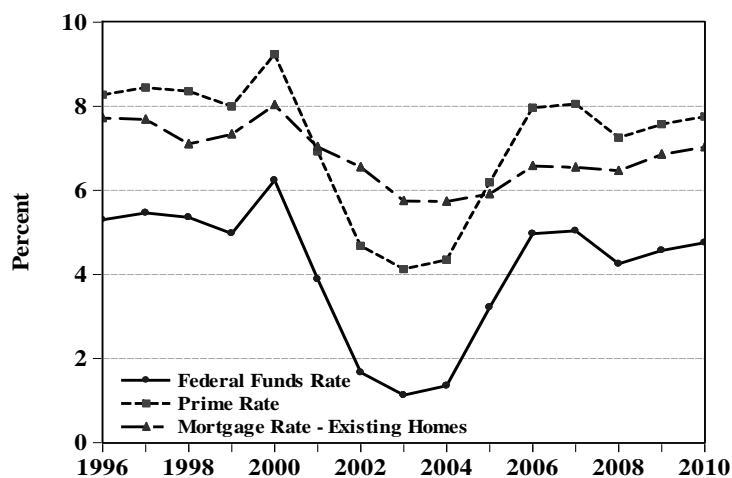
Consumer Price Inflation



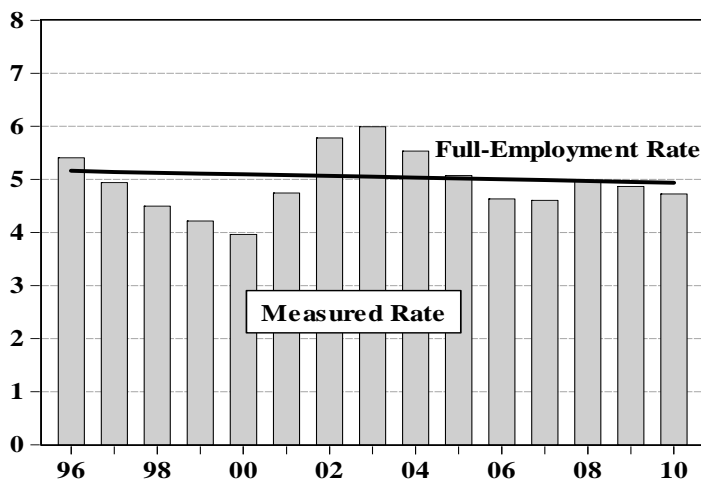
per year. This stability reflects the cooling of the labor market. In addition, wage gains are held down by recovering productivity. On the other hand, benefits will grow faster than overall employment costs, reflecting the pressure from rising health insurance costs. In summary, consumer inflation is forecast to rise 2.7% in 2007, 1.8% in both 2008 and 2009, and 1.9% in 2010. The core inflation (all items less food and energy) rate is expected to be 2.3% this year, 1.8% next year, 1.8% in 2009, and 2.0% in 2010. The Federal Reserve uses the consumer spending chain price index when determining monetary policy. This measure is expected to average just under 2.0% over the forecast period, which is just inside the Federal Reserve's 1%-2% comfort zone.

Financial Markets: Central banks are responding forcefully to credit market stresses in the United States and Europe. First, beginning in early August, the European Central Bank (ECB) and the Federal Reserve have provided much higher liquidity to the money markets. Other G-7 central banks have also provided liquidity, but on a smaller scale. Second, the Federal Reserve cut the discount rate by 50 basis points on August 17, to 5.75%, substantially broadened the collateral accepted for discount window financing, and extended the terms for borrowing from overnight to 30 days. Other central banks also altered the trajectory of their monetary policy. On September 6, the ECB deviated from its intended plan to raise interest rates, and it instead kept them unchanged. The Bank of Japan made a similar decision in late August. Third, the Federal Reserve reduced its bellwether federal funds rate by 50 basis points on September 18 from 5.25% to 4.75% and its discount rate from 5.75% to 5.25%. The federal funds reduction had been anticipated for some time. What was surprising was the size of the federal funds cut. Given the Federal Reserve's recent resistance to lowering the federal funds rate, most experts assumed the central bank would take a gradualist approach and reduce it by 25 basis points. According to the Federal Reserve, the 50-basis point reduction to its target funds rate was appropriate to help offset the effects of tighter financial conditions on the economic outlook. Without such policy actions, the tightening credit conditions and an intensifying housing correction would lead to a significantly broader weakness in output and employment. Given the expectation for a cooling economy and moderating inflation, the odds are better than even the nation's central bank will cut the federal funds rate again before this year is over.

Selected U.S. Interest Rates



U.S. Civilian Unemployment Rate



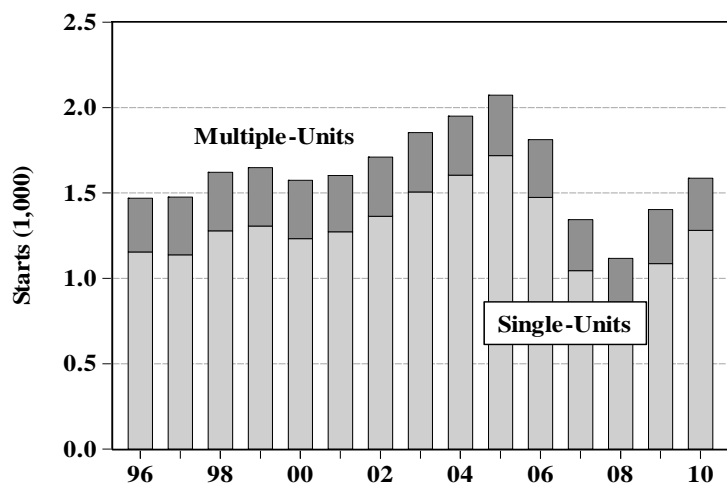
Source: Global Insight

Employment: The September payrolls report was almost as positive as the August jobs report was dreary. Payrolls fell by 4,000 in August. Moreover, previously-reported June and July estimates were revised down by a cumulative 81,000 jobs. In other words, according to the August report, the labor market lost not just one month's worth of job gains, but almost two compared to consensus expectations. The September report showed the employment picture was not as bleak as had been previously reported. Specifically, employment increased 110,000 jobs in September. But more importantly, August employment was revised from the 4,000 job decrease to an 89,000 increase. Poorly measured state and local employment was the cause of

the revision. The residential construction slump left its fingerprints all over the September jobs report, with residential construction, non-deposit financial institutions, and building material stores reporting payroll declines. Manufacturing industries with clear ties to housing (like wood, furniture, and textile product mills) accounted for almost half of manufacturing employment cutbacks. It should be pointed out that while employment has been growing, its pace has been slowing. The average monthly gains per quarter have declined steadily from 202,000 jobs in the third quarter of 2006 to 97,000 in the third quarter of 2007. The last half of 2007 through the first half of 2008 is expected to be a lean time for employment growth. During this period average monthly gains should slip further to 72,000 jobs. On an annual basis, employment is forecast to expand 1.3% in 2007 and just 0.7% in 2008—the worst showing since 2002. Employment is expected to recover slightly thereafter, posting 1.2% gains in both 2009 and 2010. The subdued job creation will cause the civilian unemployment rate to drift away from its full-employment level. This closely-watched measure is 4.6% in 2007, 5.0% in 2008, 4.9% in 2009, and 4.7% in 2010.

Housing: The U.S. housing sector has been in a recession for nearly two years. As miserable as the downturn has been, it is likely to take a turn for the worse over the second half of this year because of the turmoil in the financial markets. Recent data confirms the housing situation did not improve this summer. For example, nearly every major housing indicator—including housing starts, housing permits, and existing home sales—was down in July, while inventories of existing homes rose to a record level. Given this huge housing inventory overhang, it is no wonder home builders are in a funk. The August 2007 National Association of Home Builders/Wells Fargo Housing market index showed builders' sentiment for the next six months fell to its lowest

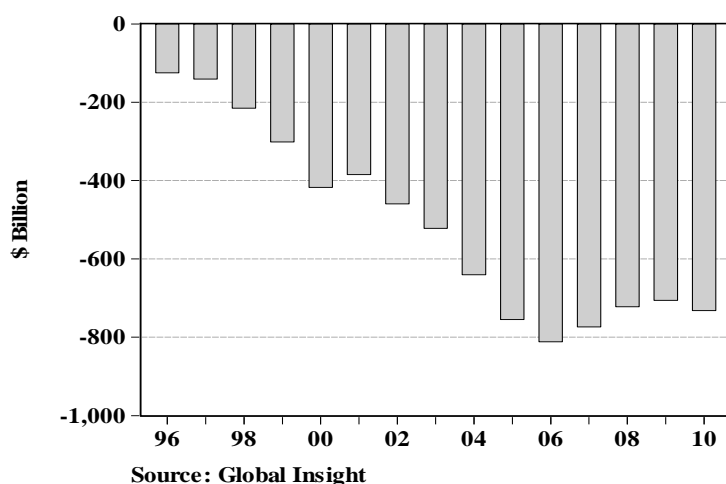
U.S. Housing Starts



Source: Global Insight

level since January 1991. Unfortunately, recent events have made it harder to work off the current housing inventory. It was much easier to get a mortgage in August than it was in September. This is especially true for subprime, Alt-A, jumbo, and adjustable loans, but even fixed-rate prime conforming loans have higher risk premiums than they had earlier this year. In some parts of the country builders have resorted to adding more amenities to their homes and cutting their prices in an effort to reduce inventory. It is the latter move that will eventually help the housing sector recover. The median price of an existing single-family home is expected to drop 2.8% in 2007 and 9.5% in 2008. These price declines will stimulate new and existing home sales. The rebound in home sales will draw down inventories and set the stage for a rebound in new home construction. While falling prices is a key ingredient in the recipe in the housing recovery, other factors also contribute to the turnaround. Over the long run, new household formations, demand for second homes, and replacement demand account for 1.5-1.7 million starts per year. Even with this support, the housing sector will recover slowly. Specifically, housing starts are expected to be 1.34 million units in 2007, 1.12 million units in 2008, 1.40 million units in 2009, and 1.59 million units in 2010.

U.S. Current Account Deficit



International: The United States' current account deficit is expected to shrink, but not disappear, over the forecast period. The current account went from having a small surplus (\$2.9 billion) in 1991 to an enormous deficit (\$811.5 billion) in 2006. Most of this increase reflects the lopsided trade situation in which imports outpaced exports. During this period imports grew an average of 9.2% per year while exports increased 6.1%. In recent years, the import bill has been distorted by the huge run-up in oil prices, such as the 22.4% increase in 2006. This situation is expected to reverse in the next few years, with exports growing 9.8% annually from 2006 to 2010 and imports advancing 5.6%. The main reasons for the export

revival are economic strength abroad and the falling dollar. The U.S. economy is forecast to grow 2.0% both this year and next. In comparison, global economic growth is predicted at about 3.5% in each of these years. Most of this growth will come from Asia, with the exception of Japan. China is the clear growth champion, averaging annual gains of about 11.0%. South America is expected to grow about 5.5% per year. Closer to home, Canada's economy is forecast to expand 2.6% in both 2007 and 2008, while Mexico's economy advances 3.0% annually. Japan's performance is slightly weaker than U.S. economic growth. The second factor favoring exports is the falling dollar. Since 2000, the greenback has lost nearly 20% of its value compared to the currencies of its major trading partners. This year two noticeable landmarks were passed. The dollar traded at parity with its Canadian cousin for the first time in over three decades and fell below its initial value against the Euro. The dollar is expected to lose an additional 12.9% of its value through 2008 before strengthening slightly in 2009. The current account deficit is expected to shrink to \$773.6 billion in 2007, \$722.2 billion in 2008, \$705.6 billion in 2009, and rise to \$757.0 billion in 2010.

Government: The federal government has been seeking a prescription for treating the ailing housing sector and mortgage credit markets. The Administration has launched the "FHASecure" program. This program allows the Federal Housing Administration (FHA) to offer mortgage insurance to an additional 80,000 homeowners beyond the 160,000 available each calendar year. Under this program, mortgage insurance would be available to homeowners who have good credit histories but only recently missed a

mortgage payment, thereby making them eligible to refinance into lower cost fixed rate mortgages. The House Ways and Means Committee passed a bill that excludes from taxation mortgage debt that is forgiven on principal residences. In addition, the bill extends the deduction for private mortgage insurance through 2014. Following the Congress “pay-go” guidelines, the bill offsets the revenue loss by tightening the capital gains rules on the sales of principal residences. Congress is also debating bills that increase the size of mortgages that the FHA could insure. Both the Senate and House versions would allow the FHA to insure loans up to 100% of the \$417,000 conforming limit for purchases by government sponsored enterprises—i.e., Fannie Mae and Freddie Mac—which is a bump from the current FHA limit of \$362,000.